Retransmission Consent Summary

1. **Congress established the current Retransmission Consent and Must Carry rules as part of the 1992 Cable Act:**
    - Maintain competition between broadcast and cable since historically cable operators had built a business by charging customers for broadcast signals that they received for free.
    - Allow Broadcasters to charge license fees to cable operators in order to retransmit their signal.

2. **ABC only negotiates retrans for its 10 owned stations. ABC always offers a standalone cash price of less than $1 per sub per month.**

3. **During the first rounds of Retransmission Consent Negotiations, Cable Operators openly refused to pay cash, but were willing to agree to other forms of consideration such as the distribution of new networks:**
    - FCC has approved these other forms of consideration that have been in place since 1993
    - Through this process, networks such as MSNBC, FX, ESPN2, Lifetime Movie Network, and SOAPnet have been launched and turned into top ranking networks.

4. **ABC's offer of less than $1 per sub per month for ABC owned stations is fair and reasonable.**
    - Cable MSOs charge consumers approximately $12 per month for "Broadcast Basic" service that primarily consists of retransmitted broadcast signals.
    - DBS charges $6 per month for local station carriage.
    - We invest more than $2 billion a year in network programming that airs on our stations.

5. **ABC has been extraordinarily flexible with smaller operators.**
    - Volume discounts available through co-ops such as the National Cable Television Cooperative, NCTC.

6. **Programming costs represent less than $11 per month for expanded basic packages for which cable operators charge customers more than $40 per month.**

8/24/2005

EXHIBIT A

DECLARATION OF BEN PYNE

I am Senior Vice President of Affiliate Sales and Marketing for ABC Cable Networks Group. Among other responsibilities, I am responsible for working with the ABC owned television stations to negotiate retransmission agreements for the ten ABC owned television stations.

I attest that, in negotiating for retransmission consent, ABC offers MVPDs a cash stand-alone price for retransmission consent for the ABC owned stations. If the cable operator accepts that offer, that decision results in no additional obligation to carry any Disney/ABC programming. To the extent that any given MVPD decides not to accept ABC's stand-alone cash offer, and instead elects the alternative to negotiate to carry programming, that decision is made by the individual MVPD. We attempt to work with the MVPD to customize a reasonable offer to address their particular needs.

I hereby declare, under penalty of perjury, that, to the best of my knowledge, information, and belief, all of the factual information contained in this Declaration is accurate and complete.

Benjamin N. Pyne
Senior Vice President of Affiliate
Sales and Marketing
ABC Cable Networks Group

February 3, 2003

DECLARATION OF BENJAMIN N. PYNE

I, Benjamin N. Pyne, Executive Vice President, Disney and ESPN Networks Affiliate Sales and Marketing, have responsibility for negotiating for multi-channel video programming distributor ("MVPD") carriage of the ABC owned television stations and The Walt Disney Company's cable networks, including ESPN, ESPN2, ESPN Classic, ESPNEWS, Disney Channel, Toon Disney, ABC Family and SOAPnet.

I attest that, in negotiating for MVPD carriage:

- Disney does not require carriage of its cable programming services in exchange for its consent to carriage of its ABC-owned television stations;
- Disney offers carriage of its ABC-owned broadcast stations for standalone cash payments;
- Disney does not require carriage of any of its other programming services before it will permit carriage of Disney Channel;
- ESPN offers the opportunity for any MVPD to carry only the ESPN service;
- ESPN does not require carriage of any of its other programming services before it will permit carriage of the ESPN service;
- An MVPD who wishes to carry Disney Channel or ESPN without carrying other Disney programming services may elect to do so;
- Disney offers MVPDs significant flexibility to choose the manner in which they carry its many services;
- MVPDs may negotiate for carriage of ESPN2 and ESPN Classic on the first, second or third most widely-penetrated tier;
- Disney negotiates for carriage of ESPN, Disney Channel and ABC Family on either the first or second most widely-penetrated tier of service;
- ESPNEWS, Toon Disney and SOAPnet may be carried on any tier;
- Disney offers all of its most popular programming services—ABC, ESPN and Disney Channel—on a standalone basis;
- An MVPD may carry ESPN but not ESPN2; and
- An MVPD may carry ABC but not SOAPnet.

I hereby declare, under penalty of perjury, that, to the best of my knowledge, information and belief, all of the factual information contained herein is accurate and complete.

Benjamin N. Pyne
Executive Vice President, Disney and ESPN
Networks Affiliate Sales and Marketing

August 12, 2004

THE FAIR MARKET VALUE OF LOCAL CABLE RETRANSMISSION RIGHTS FOR SELECTED ABC OWNED STATIONS

BY

MICHAEL G. BAUMANN

AND

KENT W MIKKELSEN

JULY 15, 2004

ECONOMISTS INCORPORATED

WASHINGTON DC

Executive Summary

The analysis examines the fair market value of local cable retransmission rights for ABC owned broadcast television station signals in three DMAs—Philadelphia, Flint, and Toledo.[1] (These stations will be referred to individually as an "ABC Owned Station" and collectively as the "ABC Owned Stations.") The analysis is based on three benchmarks. The first benchmark begins with an estimate of the retail price charged for the ABC Owned Station signals by DirecTV and DISH Network and works back to a corresponding license fee. The second benchmark begins with an estimate of what a local cable operator in each area charges its subscribers for the ABC Owned Station signal, and works back to a corresponding license fee. The third benchmark starts with an econometric analysis of the relationship between the license fees of basic cable networks and what those networks spend on programming, and then estimates the license fees that the ABC Owned Station signals would have commanded, given ABC's expenditures on programming, had they been basic cable networks. Using the average of the estimates produced by the benchmarks in each market, the fair market value of the retransmission right for the ABC Owned Station signals in the markets considered ranges from $2.00 to $2.09 per subscriber per month.

1 These markets were selected for analysis by ABC. The three markets include one large market, Philadelphia, and the two smallest markets in which ABC owns stations.

INTRODUCTION

Local broadcast stations, especially network affiliates, are an important part of the services provided by cable systems. Indeed, cable television got its start more than 50 years ago by offering improved reception of local broadcast station signals. Although cable systems now offer many other services, local broadcast station signals remain a key source of consumer demand for cable. This is not surprising. Local broadcast stations carry popular local news, weather and sports programming. Also, the national network entertainment, news and sports programming carried by network affiliates remains among the most popular programming on television. Actual and potential cable subscribers place a high value on this programming.

Cable carriage of local broadcast station signals produces revenues for cable operators. A cable operator may charge a higher subscription price for a package of programming networks if local broadcast station signals are included in the package. Alternatively, at any given subscription price, there will be more subscribers and more subscription revenue if local broadcast station signals are carried. Further, having more subscribers means that the cable operator can generate more revenue from the sale of local advertising and other services. In these respects, local broadcast station signals play a role similar to popular cable networks and other sources of cable content.

In order to generate subscriber and advertiser revenues, cable operators distribute cable networks, such as A&E, CNN, and Discovery, to their subscribers and pay monthly per subscriber fees to cable networks for such rights. Most cable networks sell advertising spots to national advertisers, and some also provide local ad availabilities to cable operators who in turn sell such local advertising spots to local advertisers.

Federal law establishes two methods by which cable systems carry local broadcast station signals—must carry and retransmission consent. Under must carry, cable systems are not required to pay local broadcast stations for the right to distribute the local broadcast station signals that they are required by federal law to carry. However, a local broadcast station may elect to instead exercise its right to grant retransmission consent. Under retransmission consent, cable systems are not required to carry the local broadcast station's signal, but must negotiate with the local broadcast station if they decide to carry the broadcast station's signal.

Broadcasters and cable operators negotiate retransmission consent agreements under rules established by the FCC. The outcome of such bargaining may result in a complex agreement. Cable operators often choose to provide alternative consideration such as carriage of cable networks that are affiliated with the broadcaster in lieu of cash payment. Because the details of each negotiation vary from one cable operator to another, and because the specific details of these agreements are generally confidential, a market price for retransmission consent rights is not transparent.

The Walt Disney Company requested us to examine two related questions arising from these circumstances. First, what is the relationship between a cash payment that a cable operator might pay for retransmission consent rights and the terms of alternative arrangements to which a local broadcast station owner and a cable operator might agree? As the next section explains, there are several ways that a local broadcast station owner that is affiliated with a cable network or cable networks can be compensated for retransmission consent rights. Second, since the market price for retransmission consent rights is not transparent, what is the estimated fair market price for the retransmission consent rights of the ABC Owned Station signals? By fair market price we simply mean the price that would be observed if retransmission consent rights were traded in cash-only transactions. Using only public or third-party data, we take three approaches:

- First, we observe the retail prices currently charged by DirecTV and DISH Network, two leading satellite operators, for their packages of local broadcast signals in each market, and we work backwards to estimate a license fee for the ABC Owned Station signal that is part of that package. Estimates range from $0.97 to $1.23 per subscriber per month.

- Second, we observe the retail price currently charged by a local cable operator in each of the markets for the tier of programming that includes local broadcast station signals, and we again work backwards to estimate a license fee for the applicable ABC Owned Station signal, which is part of that tier. This estimate ranges from $1.90 to $3.06 per subscriber per month.

- Third, we observe the relationship between what cable operators in general pay in monthly per subscriber license fees for basic cable networks and the value of basic cable networks as measured by what each spends on programming. After adjusting for the ability of the cable operator to generate revenues from local ad availabilities on certain cable networks, we use the license fee/program cost relationship to estimate what the license fee would have been for the selected ABC Owned Station signals in 2003 if they were basic cable networks. That estimate is $2.27 per subscriber per month.

Taking an average of the benchmark estimates for each market yields a fair market valuation of the retransmission rights for the selected ABC Owned Station signals ranging from $2.00 to $2.09 per subscriber per month.

CASH OR CARRIAGE?

Under the retransmission consent rules, cable operators and direct broadcast satellite distributors (collectively, multichannel video programming distributors or "MVPDs") and local broadcast television stations negotiate the terms under which MVPDs will retransmit the applicable television station(s)'s signal(s). Congress created retransmission consent rights as part of the Cable Television Consumer Protection and Competition Act of 1992. When the first transactions concerning these rights were negotiated, leading cable operators insisted that they would make no cash payments to broadcasters and subsequently initiated discussions related to launching new cable networks as possible consideration for retransmission consent rights in lieu of cash payments. Eventually, agreements were reached between the broadcast networks and the major cable operators that provided for the cable operators to carry various new broadcast network-owned cable programming services in return for retransmission consent rights to local broadcast station signals. Today, cable operators carrying cable networks as consideration for retransmission consent rights is a common practice. The FCC noted this practice in a 2000 order, and also observed that the practice is presumptively lawful.[2]

According to ABC officials, ABC offers cable systems the right to retransmit the signals of its owned stations for approximately $0.70 to $0.80 per subscriber per month. Cable operators usually decline ABC's cash offer and instead negotiate a customized deal that compensates ABC while meeting the operators' particular needs. We understand that ABC is open to any options that provide ABC with fair consideration for its owned station signals, and ABC works with cable operators to determine what form that consideration may take if the cash option is not accepted by the cable operators.

To illustrate, the following are some of the alternatives ABC has used in order to address the particular circumstances of individual operators: (a) a cable operator may

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2 FCC, First Report and Order, In the Matter of Implementation of the Satellite Home Viewer Improvement Act of 1999 and Retransmission Consent Issues: Good Faith Negotiation and Exclusivity, CS Docket No. 99-363, released March 16, 2000, ¶ 56, point 3.

agree to launch or reposition a cable network to reach more subscribers; (b) a cable operator could extend the term of an existing cable network distribution agreement; and (c) if a cable operator faces capacity constraints in a cable system within an ABC Owned Station's DMA, the operator may agree to launch a cable network outside of the applicable DMA. From an economic perspective, the opportunity to transact in a variety of "currencies" may increase the potential gains to the two parties from a transaction, but it does not alter the parties' respective shares of the gains. Under the various options that ABC offers to cable operators, ABC simply attempts to obtain consideration comparable to the cash option.

EXECUTIVE SUMMARY

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ESTIMATED FAIR MARKET PRICE

Using DirecTV and DISH Network prices as a benchmark

DirecTV and DISH Network are the two major direct broadcast satellite (DBS) providers in the United States, with a current combined total of over twenty million subscribers. Legislation enacted in 1999 gave DirecTV and DISH Network the right to carry local broadcast stations. Both companies compete with cable television operators for subscribers, and both carry many of the same networks as cable systems. We therefore assume that DirecTV and DISH Network subscribers are representative of cable subscribers in their valuation of local broadcast signals, and that the relationship between wholesale and retail prices for such programming on DirecTV and DISH Network is indicative of the corresponding relationship for cable systems, and vice versa.

Any subscriber to DirecTV in a market where DirecTV provides local signals can add a package of local broadcast channels for $6.00 per month.[3] DirecTV currently offers such local programming in Philadelphia and Flint.[4] A subscriber to DISH Network in those markets with a local signal package can add the package for $5.99 per month. DISH Network also currently offers a local programming package in Philadelphia and Flint. Given the competitive importance to DBS services of offering local channels, DBS providers may provide these packages at reduced rates to spur subscribership.[5] If so, our estimates based on this benchmark will understate the fair market value of retransmission rights.

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3 Beginning in March 2004, if a subscriber purchases a DirecTV package with local channels, the subscriber gets a $3 bundling discount. But if the subscriber only had Select Choice or some kind of special package or a complimentary package, and wanted to add the local channels, then the additional cost would be $6. See copy of a June 2004 DirecTV monthly statement attached as Appendix A.

4 DirecTV plans to begin offering local signals in Toledo in 2004.

5 The FCC noted that the growth in DBS subscribers is, in part, attributable to the authority granted to them to distribute local broadcast television stations. FCC, *Tenth Annual Report: Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket 03-172, ¶¶8, 65.

In each market, both the DirecTV and DISH Network packages include programming from several local stations. It is unlikely, however, that the signals have equal value, either to subscribers or to DirecTV or DISH Network in attracting subscribers. For purposes of our analysis we assume that the value of the stations included in either the DirecTV or DISH Network local package is proportional to the stations' shares of local audience.[6] Using data from the May 2004 sweeps, we determine the total day viewing share of each programming service included in each market's local channel package.[7] We then compute each ABC Owned Station signal's share of viewing relative to all services in the package.

We attribute to each ABC Owned Station signal a percentage of the retail value of the local channel package based on its relative share of viewing of services in the package. The results are presented in Table 1. The implied retail value for an ABC Owned Station signal ranges from $1.64 to $2.08 based on the DISH Network price and from $1.65 to $2.09 based on the DirecTV price.

Table 1: Estimated retail value of ABC Owned Station signals based on DBS fees

	DISH Network ($5.99/mo.)		**DirecTV ($6.00/mo.)**	
Market	ABC Owned Station Viewing Share	Attributed Value	ABC Owned Station Viewing Share	Attributed Value
Flint	34.8%	$2.08	34.8%	$2.09
Philadelphia	27.5%	$1.64	27.5%	$1.65
Toledo	n.a.	n.a.	n.a.	n.a.

To derive an estimate of market value for local broadcast retransmission rights, we need to translate this retail value into a corresponding wholesale value or license fee.

6 Viewers' demand or willingness to pay for programming is not the same as ratings or viewing shares. In theory, programming with a relatively small audience that is intensely interested may command higher revenue than programming that attracts a larger but less interested audience. Lacking direct measures of viewer willingness to pay for individual broadcast networks, we use ratings and viewing shares as an approximation.

7 Underlying data are from Nielsen.

To do this, we make use of the relationship between wholesale license fees and subscriber prices observed for other programming. In 2002, wholesale revenue for premium services was about 59 percent of retail revenue for such services.[8] Applying this percentage implies that the wholesale value to ABC Owned Station signals would range from $0.97 to $1.23, based on both the DISH Network prices and the DirecTV prices. See Table 2. This percentage is equivalent to a retail markup over wholesale of about 70 percent. Since DBS providers would likely apply a very low or no markup to the license fee given the competitive importance of local signals to DBS services, as noted above, the actual retail markup may well be lower than 70 percent and therefore the wholesale values are likely to be higher than estimated here.

Table 2: Estimated wholesale value of ABC Owned Station signals based on DBS fees

Market	DISH Network	DirecTV
Flint	$1.23	$1.23
Philadelphia	$0.97	$0.97
Toledo	n.a.	n.a.

Using the local cable operator's basic tier price as a benchmark

Our second approach to estimating a fair market value for retransmission of the ABC Owned Station signals is to look at the retail price a local cable operator charges for the service tier that includes the ABC broadcast station and then work backwards to an implied wholesale value.[9]

Most cable operators provide a Basic Service Tier that functions primarily as a "reception" package. The tier is typically composed of local broadcast television stations and government access channels. Most likely, as with the satellite local signal packages, this price is below fair market value. Although some cable television prices have recently

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8 Kagan World Media, *The Pay TV Newsletter*, July 31, 2002, p. 3. Kagan estimated that the wholesale percentage of retail revenue was 59.1 percent in 2002 and would be about 59.5 percent in 2004.

9 The cable operators selected were identified as serving the named city.

been deregulated at the federal level, basic tier prices remain regulated by state and local authorities. Such tiers are often offered at a discount for regulatory or public relations reasons, to satisfy agreements with local agencies or to improve relations with the FCC or franchise authorities. Historically, few cable subscribers opt for only this basic service. Therefore, cable operators lose little by offering a low price. Nevertheless, we assume that the Basic Service Tier price reflects market value. If the retail price is below fair market value, our estimate of the corresponding wholesale price again understates the fair market value of retransmission rights.

We again assume that the value attributable to an individual channel on this tier is proportional to its ratings relative to all the channels on the tier.[10] See Table 3.

Table 3: Estimated value of ABC Owned Station signals based on cable operator fees

Market	Operator	Rate	Number of Channels	ABC Owned Station Viewing Share	Attributed Retail Value	Estimated Wholesale Value
Flint	Comcast	$12.75	19	33.3%	$4.25	$2.51
Philadelphia (19132)	Comcast	$15.60	32	27.5%	$4.28	$2.53
Philadelphia (19102)	Comcast	$20.00	34	25.9%	$5.19	$3.06
Toledo	Buckeye	$12.15	19	26.5%	$3.22	$1.90

Based on the relative share of viewing in each market, approximately 20 percent to 30 percent of the value of the basic service tier is attributable to the ABC Owned Station signal. The retail value attributed to the ABC Owned Station signals ranges from $3.22 to $5.19. We again assume that the wholesale value is 59 percent of the retail value. This implies a wholesale value, or retransmission license fee, ranging from $1.90 to $3.06 for the ABC Owned Station signals.

10 See note 6. Many services on the basic service tier have no ratings reported by Nielsen. The absence of ratings data generally implies that the audiences are too small to be measured accurately. We assumed that these services had a zero share.

Using cable network license fees as a benchmark

Our third approach to the question of estimating the fair market value of local cable retransmission rights to the ABC Owned Station signals relies on what cable operators pay for various cable networks. The economic foundation of basic cable networks is the cable operators' ability to distribute cable networks to viewers for monthly subscription fees as well as to deliver audiences to advertisers. Cable operators pay license fees to distribute cable networks, such as ESPN or CNN. These license fees (wholesale prices) are determined by free market competition.

There is a strong correlation between the license fees paid by cable operators to cable networks and the level of programming expenditure by those cable networks. See Figure 1.[11] It is not surprising to find that more popular, expensively-produced cable networks have higher license fees than do less popular cable networks. We rely on this relationship between cable network programming expense and cable network license fees to project the value of broadcast station signal retransmission consent rights based on broadcast network programming expenses.[12]

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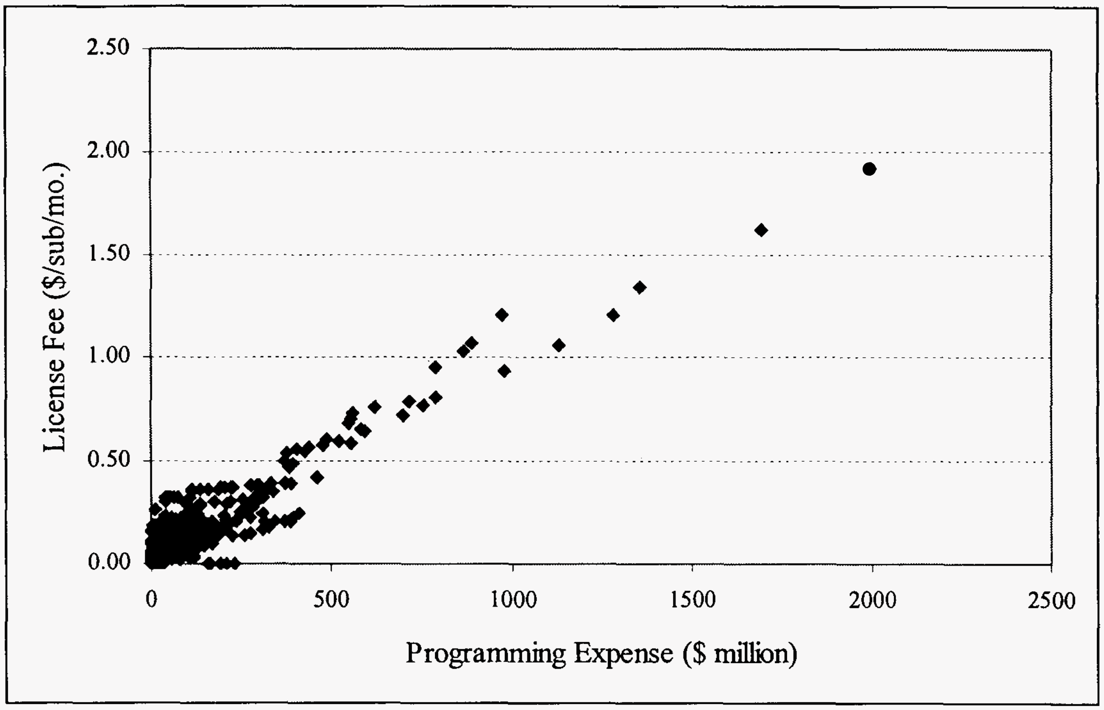
11 Data from Kagan Research, *Economics of Basic Cable Networks 2005: Key Spreadsheets*, June 2004. Programming expenses and license fees expressed in real 2003 dollars using the GDP implicit price deflator.

12 The fee cable operators (and ultimately, viewers) are willing to pay for a program service depends on the quality or attractiveness of the programming provided. Higher perceived programming quality, in turn, is directly related to programming expense. This is so because competition among distributors drives up the prices of the most attractive program services. Therefore, one would expect that license fees per subscriber would increase as programming expenditures increase, other things equal. See B. Owen and S. Wildman, *Video Economics*, 144-150 (1992); B. Litman, *Predicting Success of Theatrical Movies: An Empirical Study,* 16 Journal of Popular Culture 159 (1983); and M. Blumenthal, *Auctions with Constrained Information: Blind Bidding for Motion Pictures*, 70 Review of Economics and Statistics 191 (1988).

Figure 1: Cable network license fees versus programming expenses, 1992-2003
(in real 2003 dollars)



Although very important, program expense is not the only factor that explains the license fees commanded by cable networks. Many cable networks receive not just license fees from cable operators but also advertising revenues from national advertisers. Each cable network must decide how to trade off these two sources of revenue. Other things being equal, if a cable network's per subscriber wholesale license fee is lower, cable operators will provide it to more subscribers than more expensive cable networks. Such more widely distributed cable networks will accordingly be more attractive to advertisers and could result in greater advertising revenue. This tradeoff has become more important as the cable advertising marketplace has grown in the last decade. Our analysis takes this tradeoff into account.

A related issue in understanding cable network license fees is the availability of local advertising spots. A cable operator will be willing to pay more, other things being equal, for a cable network that provides opportunities for the cable operator to sell local advertising spots. In doing this, of course, the cable network gives up the opportunity to sell such spots to national advertisers. Because local cable advertising has grown in importance, this effect must now also be taken into account for purposes of estimating the fair market value of broadcast retransmission rights.

Kagan Research's publication *Economics of Basic Cable Networks 2005* provides data regarding basic cable networks.[13] For purposes of our analysis, we use data on 94 cable networks for 12 years (not all cable networks were in operation in every year), as depicted in Figure 1.[14] We adjust these data for inflation and then use an econometric technique (regression analysis) to estimate the overall average relationship between license fees and programming expenditures. See Appendix B. We apply the resulting relationship to programming expenditures by the ABC network in 2003 as reported by Kagan Research.[15] The result is an imputed monthly license fee that the ABC network could command as a basic cable network.[16] That number is $3.00 per subscriber per month.

As indicated above, economic analysis of the cable industry suggests that we should also take into account the growing importance of cable advertising revenue. In theory, this should tend to reduce license fees. We account for this by including for each cable network an estimate of its advertising revenue in each year. The result is that the imputed monthly license fee for the ABC network drops to $2.81 for the year 2003.

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13 The FCC regularly relies on the industry statistics and projections by Kagan Research in its rulemaking decisions and analyses of the video industry. See, e.g., FCC, *Tenth Annual Report*, Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, MB-Docket 03-172.

14 The *Economics of Basic Cable Networks 2005* lists subscriber, license fee and programming expense data for 120 cable networks. For various reasons, 26 networks were excluded from the analysis—8 had data starting only in 2004; 9 had only one year of usable data; 3 were premium networks for part of the time period; 5 were Spanish language; and 1 was a delayed feed of another.

15 Kagan Research, "Broadcast Network Economics, 2001-2003," *TV Program Investor*, May 27, 2004.

16 The prediction relates to the average fee paid by all cable operators. To apply this methodology to an individual cable operator we would need to know that operator's license fees for the cable networks it carries and that operator's local advertising revenues per network.

As explained above, cable operators derive local advertising revenue from some cable networks. Broadcast station signals do not afford such an opportunity, and other things being equal this reduces the value of broadcast station signals to cable operators relative to cable networks that offer local advertising availabilities. To account for the value of local advertising availabilities to cable operators, we include a variable that measures the value of local cable advertising attributable to each cable network. The effect of this adjustment is to reduce the imputed value of the ABC network monthly license fee to $2.27 per subscriber.

The preceding analysis may understate the value of the ABC Owned Station signals because it does not take into account the value of local and other non-network programming. Our evaluation of the ABC network if it were a basic cable channel omits any consideration of the local content of the ABC stations' signals. The cable networks used to estimate the value of ABC retransmission rights generally do not offer local content. If it were possible to take this into account it would likely increase the license fee that an ABC Owned Station signal could command above the value associated with the ABC network programming.

CONCLUSION

Table 4 summarizes the estimated values of the ABC Owned Station signals from each of the three methods.

Table 4: Summary of retransmission value estimates

Market	DBS	Cable	Regression	Average
Flint	$1.23, $1.23	$2.51	$2.27	$2.00
Philadelphia	$0.97, $0.97	$2.53, $3.06	$2.27	$2.01
Toledo	n.a.	$1.90	$2.27	$2.09

If we give the average value of each method's estimate obtained within a market equal weight, we obtain the average valuation reported in the last column of Table 4. Using these averages, the fair market value of the retransmission right for the ABC Owned Station signals in the markets considered ranges from $2.00 to $2.09 per subscriber per month.

Appendix A: Sample DirecTV Monthly Statement

DIRECTV

View Statements
Payment History

Customer Profile
Payment Profile
Terms and Conditions
Logout

Monthly Statement

Billing Address	Service Address:
[redacted]	[redacted]
N	HERMOSA BEACH, CA
HERMOSA BEACH, CA	90254-[redacted]
90254-[redacted]	

Date Due	Account Number	Amount Due
Not Due	**013937684**	**No payment due**

Account Summary

Bill Statement Date		
06/09/2004	**Previous Balance**	0.00
	(-) Payments and credits	15.98
	(+) Current charges and taxes	15.98
	= AMOUNT DUE	**$0.00**

Account Activity

Access Card	Start	End	Description	Amount
			Previous Balance	0.00
	06/09/04		Payment - Thank You - VISA	- 15.98
1405-353192			***Subscriptions***	
	06/08/04	07/07/04	Premier Bonus: You Save $4.99 DIRECTV DVR	0.00
	06/08/04	07/07/04	Complimentary TOTAL CHOICE PREMIER	0.00
	06/08/04	07/07/04	Monthly Your Local Channels	6.00
1382-142063			***Subscriptions***	
	06/09/04		Additional Receiver	4.99
1390-093225			***Subscriptions***	
	06/09/04		Additional Receiver	4.99
			AMOUNT DUE	**$0.00**

Appendix B: A statistical model of television network license fees

The fees MVPDs (and ultimately, viewers) are willing to pay for programs depend on the quality of the programs provided. Higher perceived program quality, in turn, is directly related to program expense. Therefore, one would expect that license fees per subscriber would increase as program expenditure increases.[17]

An appropriate statistical model relates cable network license fees to their main determinants, program expenditures and network advertising revenues. Once this relationship is estimated, the estimated model predicts a fair market value fee for the broadcast networks. The general form of the statistical model is as follows:

$$\text{Fee}_{it} = \beta_0 + \beta_1 \bullet \text{Program Expense}_{it} + \beta_2 \bullet \text{Advertising Revenue}_{it} + \beta_t \bullet \text{Year Dummy} + \varepsilon_{it}$$

where Fee is the average per-subscriber per-month licensing fee, Program Expense is the annual program expenditure, Advertising Revenue is the annual net advertising revenue, ε is a statistical error term, subscript i indicates network i, and subscript t indicates year t. The model allows for individual year-specific effects, β_t.

Two changes were made to this general form for the final version of the regression. First, since the license fee may depend on the ability of the cable operator to insert local advertising, a variable was included to account for local cable advertising revenue attributable to each network.[18] In addition, the intercept term, β_0, is allowed to

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17 Data on license fees, program expenditures and the number of subscribers for 94 basic cable networks are obtained from Kagan Research, *Economics of Basic Cable Networks 2005: Key Spreadsheets*, June 2004. While Kagan provides data for 120 cable networks, 26 networks were excluded from the analysis. See footnote 13.

18 Total local cable advertising revenue is from Paul Kagan Associates, *The Kagan Media Index*, September 30, 2000, and *Kagan Media Money*, August 29, 2003. The percentage of local ad revenue attributable to each cable network is from "Average Share of Local Cable Ad Revenue by Network," Paul Kagan Associates, *Broadband Advertising*, December 13, 2001. Data on the share of local cable ad revenue were available only through 2000. Shares for 2001, 2002, and 2003 are assumed to be the same as in 2000.

vary by network, using the assumption that the intercept will be a function of the average program expenditure of the network over the observed period.

The equation estimated is

$$\text{Fee}_{it} = \beta_0 \bullet \text{Average Program Expense}_i + \beta_1 \bullet \text{Program Expense}_{it} + \beta_2 \bullet \text{Advertising Revenue}_{it} + \beta_3 \bullet \text{Local Advertising Revenue}_{it} + \beta_t \bullet \text{Year Dummy} + \varepsilon_{it}$$

where Average Program Expense is the average program expense over the period for which there exist data for the network and Local Advertising Revenue is the average per-subscriber per-month local advertising revenue.

All variables are expressed in real 2003 dollars, using the GDP implicit price deflator. Standard (OLS) estimation of the model produces the following results:[19]

Model estimation results

F: 431.4		Pr > F: <.0001		
R^2: 0.9007		Root MSE: 0.0574		
Parameter	Estimate	T-value for H_0:Parameter=0	Pr > |T|	Std. Error of Estimate
β_0	0.0001765	4.74	<.0001	0.0000372
β_1	0.0009072	26.55	<.0001	0.0000342
β_2	–0.0003077	–12.35	<.0001	0.0000249
β_3	0.3718	8.57	<.0001	0.04341
β_{2003}	0.05161	8.34	<.0001	0.00619

19 The last term in the model is an error term, which is the difference between the predicted results and the actual observation. OLS, ordinary least squares, is a procedure that minimizes the sum of the squares of the error terms—hence, the phrase "least squares." The OLS estimator is a standard statistical procedure that gives the best, straight-line, unbiased estimate of the relationship between the variables.

From the model results, it is possible to construct an equation that estimates the free market value of retransmission of the ABC Owned Station signals. For the program expense of the ABC Owned Stations we use the program expense of the ABC network. This is conservative since it ignores both expenditures on and the nature of local news, local sports, other locally originated programming and syndicated programming on the stations. ABC's programming expenditure for 2003 was $3,010 million and its net advertising revenue in 2003 was $3,169 million.[20] ABC's average annual real programming expenditure from 1992 through 2003 was $2,624.9 million.[21] Using these values gives an estimated license fee of $2.27 per subscriber per month.[22]

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20 "Broadcast Network Economics, 2001-2003," Kagan Research, *TV Program Investor*, May 27, 2004.

21 "Broadcast Network Economics, 1991-1993," Paul Kagan Associates, *TV Program Investor*, February 28, 1994; "Broadcast Network Economics, 1993-1998," Paul Kagan Associates, *TV Program Investor*, April 15, 1999; "Broadcast Network Economics, 1997-1999," Paul Kagan Associates, *TV Program Investor*, April 20, 2000; "Broadcast Network Economics, 2000-2002," Kagan World Media, *TV Program Investor*, June 26, 2003; "Broadcast Network Economics, 2001-2003," Kagan Research, *TV Program Investor*, May 27, 2004.

22 The 95 percent confidence interval on this estimate is plus or minus 19¢.

CAP ANALYSIS

RETRANSMISSION CONSENT
AND CABLE TELEVISION PRICES

March 31, 2005

Jeffrey A. Eisenach
Executive Vice Chairman

Douglas A. Trueheart
Senior Vice President

Note: Support for this study was provided by The Walt Disney Company. The views expressed are those of the authors. CapAnalysis is an economic and financial consulting firm located in Washington, DC. For more information, visit www.capanalysis.com.

<u>Contents</u>

List Of Exhibits

I. INTRODUCTION

We have been asked by The Walt Disney Company to evaluate a report by William P. Rogerson that was submitted to the Federal Communications Commission (FCC or Commission) by the Joint Cable Commenters (JCC) as part of the Commission's *Inquiry on Rules Affecting Competition in the Television Marketplace.*[1] Professor Rogerson and JCC argue that retransmission consent "has been a major contributing factor to the size and price of the expanded basic tier."[2] Specifically, Professor Rogerson concludes that,

> [S]ince the passage of retransmission consent, the Big Four broadcasters have grown to dominate the MVPD network programming industry. Subscription prices for cable TV have risen significantly over the past decade, and there is wide agreement that increases in programming costs have been an important factor fueling these price rises. .... [T]he passage of retransmission consent regulations likely played a major role in contributing to these increases in programming costs by allowing broadcasters to exercise their market power over their broadcast signals.[3]

We examine these issues and conclude that: (a) cable prices are not rising rapidly, especially when adjusted to reflect changes in quality; (b) programming costs account for a very small proportion of recent cost increases experienced by cable operators, the bulk of which are associated with their investments in new digital infrastructure and services such as broadband and telephony; (c) retransmission consent does not harm competition or consumers, but instead contributes to consumer welfare in the markets for broadcast/MVPD programming and distribution.

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[1] William P. Rogerson, "The Social Cost of Retransmission Consent Regulations," (February 28, 2005) (submitted as Attachment A to Comments of Joint Cable Commenters, MB Docket No. 05-28, March 1, 2005). Hereafter, "Social Cost" and "JCC Comments," respectively.

[2] JCC Comments at 5.

[3] Social Cost at 19.

In Section II of this report, we examine the relationship between programming costs and cable rates. Section III focuses on the competitive effects of retransmission consent. Section IV presents a brief summary.

II. PROGRAMMING COSTS ARE NOT DRIVING INCREASES IN CABLE RATES

Professor Rogerson argues that "cable subscription prices have been rising at a very fast rate since passage of the Telecommunications Act in 1996,"[4] and that "there is wide agreement that increases in programming costs have been an important factor fueling these price rises."[5] Retransmission consent is responsible, he says, because it allows broadcasters to "negotiate some combination of higher license fees and increased carriage than they otherwise would have been able to negotiate."[6]

We examined the determinants of cable rates in some detail in a 2003 study.[7] We concluded then that,

> ...cable rates, properly understood, are not rising faster than the rate of inflation – indeed, in real terms they are falling. Moreover, programming costs represent only a small fraction of the overall cost increases experienced by cable TV operators in recent years, and clearly are not the primary driver of retail rates.[8]

In this section, we review the most recent data, and conclude that cable rates, properly understood, are still not rising faster than inflation, and programming costs are still not the primary driver of cable cost structures.

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[4] Social Cost at 17.
[5] Social Cost at 19.
[6] Social Cost at 37.
[7] Jeffrey A. Eisenach and Douglas A. Trueheart, *Rising Cable TV Rates: Are Programming Costs the Villain,* CapAnalysis, LLC (October 23, 2003). Hereafter "2003 Report."
[8] 2003 Report at 1.

A. Quality Adjusted Cable Rates Are Not Rising Rapidly

Each year, the Commission surveys a random sample of cable operators and publishes a report on changes in cable industry prices.[9] The survey provides a basis for estimating prices paid by subscribers for basic and expanded basic (hereafter collectively referred to as "basic") programming services.

At the time of our 2003 report, the data showed that monthly basic subscription rates had risen by 8.2% during in the preceding period (July 2001-July 2002), much faster than the consumer price index, which rose by 1.5%. We argued then, however, that monthly subscription prices fail to take into account changes in quality, such as the number of channels of programming. We showed then that when such factors were taken into account, cable television prices were level or actually falling in real terms. The same results hold today.

The Commission's most recent survey indicates that basic rates increased by 5.4% between January 1, 2003 and January 1, 2004, a period during which consumer prices as a whole, as measured by the rise in the consumer price index, rose 1.1%. Furthermore, over the five-year period ending January 1, 2004 basic cable rates rose at an annual rate of 7.5% compared with 2.1% for the consumer price index. In other words, just as in 2003, the survey seems on its face to suggest that basic cable rates are rising faster than inflation.

As we noted in 2003, however, this data "fails to take into account improvements in product quality, most notably a substantial increase in the number of channels offered

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[9] See Federal Communications Commission, *Report on Cable TV Prices*, MM Docket No. 92-266 (February 4, 2005) (hereafter "Cable Price Report"). (The most recent report moved the reporting period from July-July to January-January.)

as part of basic cable programming packages."[10] Cable subscribers place a high value on programming variety and diversity, as evidenced, for example, by the fact that these product attributes have played a key role in the highly successful efforts of DBS providers to win customers away from cable operators.[11] Thus, it is appropriate to adjust cable subscription prices to reflect changes in the number of channels carried, i.e., to measure cable prices by the cost per channel.

The FCC agrees this is an appropriate basis by which to measure cable rates, and in fact does so in its report. Between January 1, 2003 and January 1, 2004, the Commission reports, the average number of channels carried on the basic tier increased from 67.5 to 70.3. As reflected in Exhibit One below, adjusting the increase in subscription rates to reflect this growth in channels shows that the rate per channel rose by only 1.1% during 2003, and only 0.4% annually over the past five years. Thus, on a per channel basis, over the past five years rates have risen more slowly than inflation.

Exhibit One:
Changes in Cable TV Rates, 1999-2004

	Increase in Average Monthly Rates	Increase in Average Monthly Rate Per Channel	Consumer Price Index
Jan. 2003 to Jan. 2004	5.4%	1.1%	1.1%
5-year average (Jan. 1999 to Jan. 2004)	7.5%	0.4%	2.1%

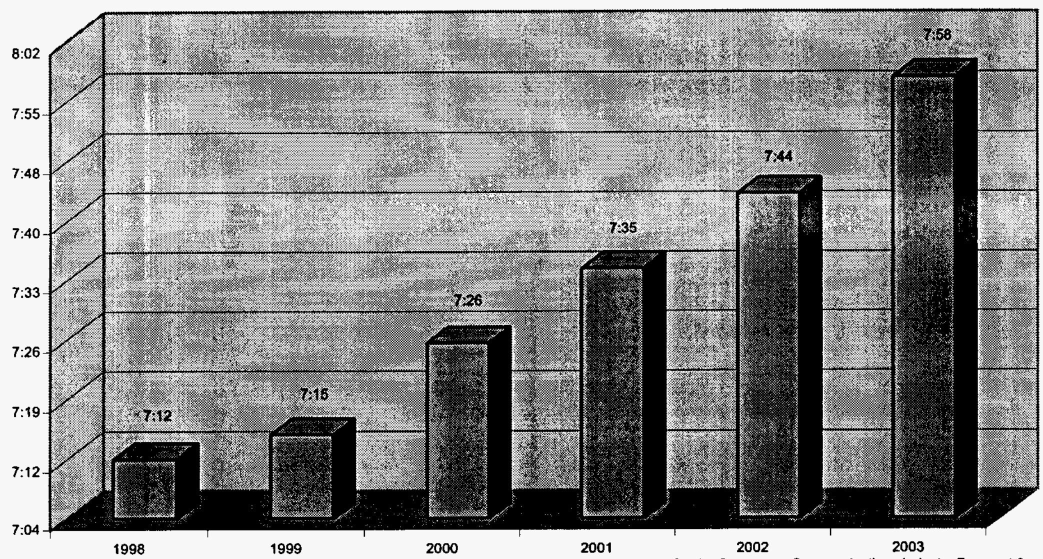
Source: Cable Price Report at 9.

[10] 2003 Report at 4.

[11] See, e.g., the first item on the list of competitive advantages listed by DirecTV on its web page: "The DIRECTV® TOTAL CHOICE® package gives you over 125 digital channels for $41.99/mo, including your local channels. For the same price with cable, you'll typically get 60-90 analog channels." (www.directv.com/DTVAPP/get_directv/directv_vs_cable.dsp, viewed March 28, 2005).

Professor Rogerson suggests that the additional channels being carried on cable networks are of little or no value to consumers.[12] Yet there are numerous indicators that consumers value the increasing quality and diversity of cable TV programming. For example, as shown in Exhibit Two below, the actual viewing time of cable TV households increased by 46 minutes, or more than 10%, between 1998 and 2003. And, as shown in Exhibit Three, cable's share of that time increased as well, from only 50% in 1998 to 60% in 2003.

EXHIBIT TWO:
TV Viewing per Household (in hours)



Sources: Kagan Media Trends 2002 (pg. 251); 2002 and 2003 calculated based on growth data from "Veronis Suhler Stevenson Communications Industry Forecast & Report," 2004.

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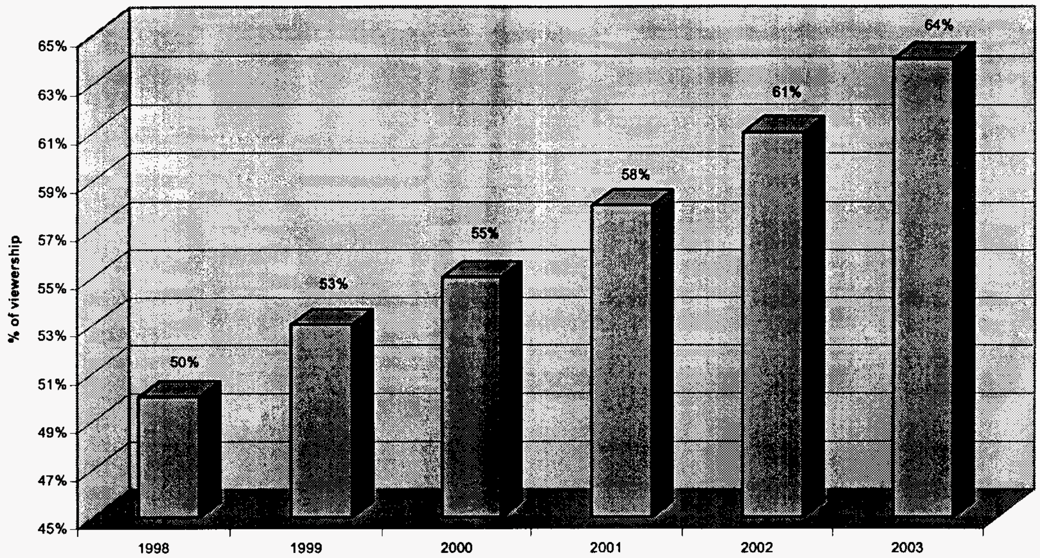
[12] See Social Cost at 4 (arguing that cable operators are forced to "purchase additional programming that they might otherwise not have purchased" and "Consumers also are harmed because these tie-ins...distort the selection of programs that is available to MVPD subscribers.")

EXHIBIT THREE:
Cable Share in Cable TV Households



SOURCE: Kagan Economics of Basic Cable Networks 2005 (pg. 46)

Using this above data, we can calculate what is perhaps the most valid measure of the value received by cable subscribers: cost per hour viewed. As reflected in Exhibit Four, the nominal price per hour viewed for cable subscribers decreased at an average annual rate of 1% from 1999 through 2003, while the consumer price index increased at an average annual rate of 2.1% over the same period. Thus, the inflation adjusted price per viewing hour actually decreased by 6.8% during the period.[13]

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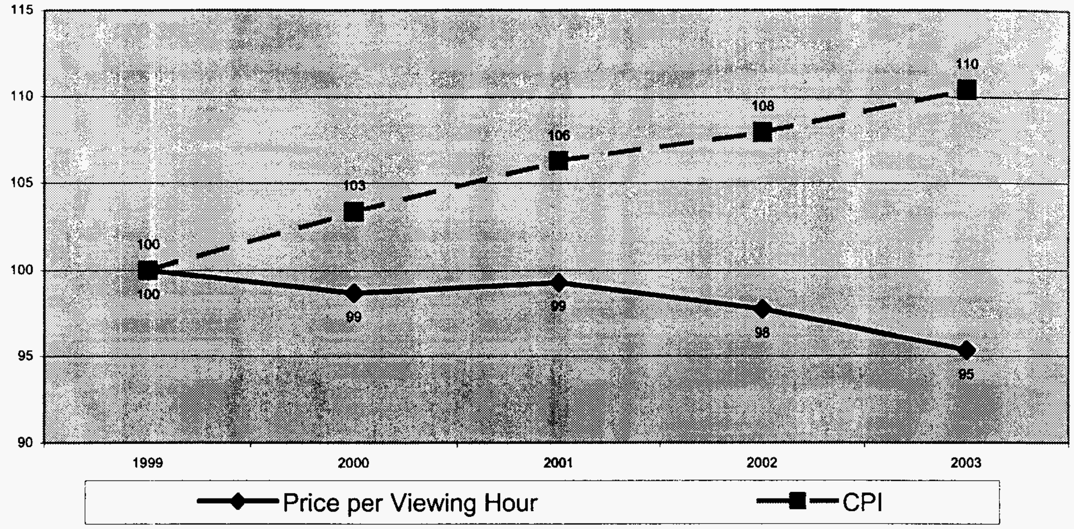
[13] The conclusion that inflation adjusted price per viewing hour is actually decreasing is also supported by a study by Professor Steven Wildman sponsored by the NCTA. Professor Wildman concluded that the inflation adjusted price per viewing hour decreased by more than 15 percent over the ten-year period from 1993 through 2003. See Steven Wildman, "Assessing Quality-Adjusted Changes in the Real Price of Basic Cable Service" (September 10, 2003; attachment to NCTA Comments in MB Docket 03-172.)

EXHIBIT FOUR:
Cable Television Price per Viewing Hour vs. CPI, 1999-2003
(Index: 1999 = 100)



The increase in TV viewing cited above also suggests that subscribers feel that the quality of the programming being provided has also increased, as evidenced by the fact that the number of prime time Emmys received by cable companies increased by 254% from 1992 through 2003.[14] This increasing quality is not free. As indicated in Exhibit Five below, programming expenditures by the national cable program networks increased at an average annual rate of 14% from 1999 through 2005, much faster average annual increase in cable rates charged to basic subscribers found by the FCC for the same period. [15]

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[14] Social Cost at 58.

[15] The increase in programming costs also reflects increased capital expenditures and operating costs associated with producing digital and high definition content. While these costs are difficult to quantify, in part due to the fact that they have been incurred in large part by independent, privately-held production companies, they are certainly significant.

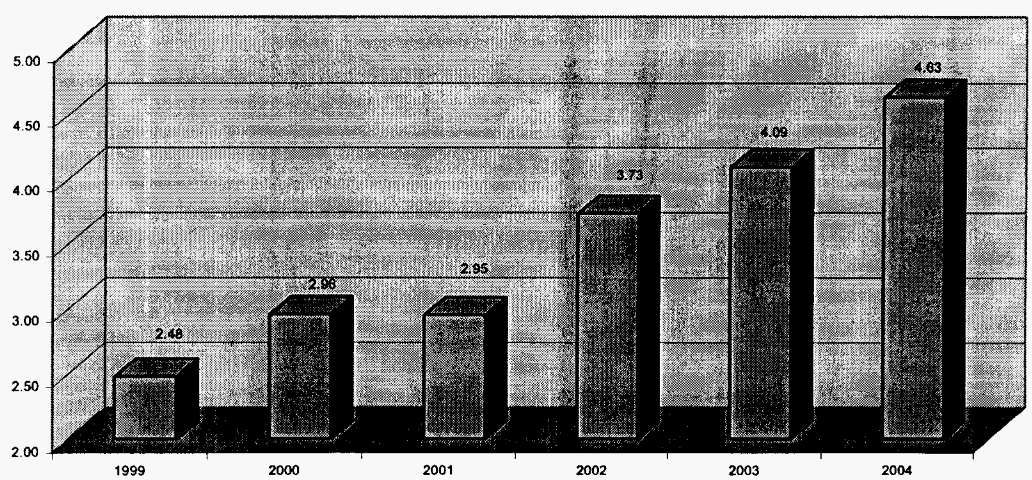
EXHIBIT FIVE:
Programming Expenditures of MVPD Networks

Year	Millions of $	Annual % Change
1999	$6,445	18.0%
2000	$7,265	12.7%
2001	$8,024	10.4%
2002	$9,072	13.1%
2003	$10,413	14.8%
2004	$11,559	11.0%
2005$^{est.}$	$12,862	11.3%

Source: Kagan, "Broadband Cable Financial Databook," 2004.

It should also be noted that that the increase in the quality of programming and the corresponding increase in viewership have resulted in a direct benefit to the cable operators: an increase in advertising revenues. As indicated in Exhibit Six below, on a per subscriber basis net advertising revenue to the cable operators increased by 13% from 2003 to 2004 and by 87% from 1999 through 2004. At least a portion of this increase should be used to offset the costs of programming.

EXHIBIT SIX:
Monthly Cable Operator Advertising Revenues per Subscriber
1999-2004



Source: 2004 Kagan

B. Programming Costs Are Not Driving Cable Cost Increases

Professor Rogerson argues it is "well recognized" that "cable operators' costs of purchasing programming have also been rising at a very rapid rate and that a substantial share of the price increases that consumers have experienced simply reflects a pass-through of these cost increases."[16] In support of this proposition, he cites a March 2004 report by the General Accounting Office,[17] and a 2003 rebuttal, by Rogerson himself, of our October 2003 report.[18] His interpretation of the GAO report is misleading, and his 2003 report is simply incorrect.

Rogerson quotes one paragraph from the 21-page GAO report, which concludes that programming costs are "one important factor contributing to higher cable rates."[19] But GAO also found that "a variety of factors contribute to cable rate increases,"[20] that "the cable industry has spent over $75 billion between 1996 and 2002 to upgrade its infrastructure," and that "investments in system upgrades contributed to increases in consumer cable rates."[21] Perhaps most importantly, the GAO report found that "competition among networks to produce and show content that will attract viewers has become more intense," "bid up the cost of key inputs," "sparked more investment in

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[16] Social Cost at 18.

[17] "Subscriber Rates and Competition in the Cable Television Industry," *Statement of Mark L. Goldstein, Director, Physical Infrastructure Issues, U.S. General Accounting Office, Before the Committee on Commerce, Science and Transportation, U.S. Senate*, (March 25, 2004). (Hereafter "GAO 2004.") (The GAO's name has since been changed to the "Government Accountability Office.")

[18] William P. Rogerson, Correcting the Errors in the ESPN/CapAnalysis Study on Programming Cost Increases (November 11, 2003). (Hereafter, Rogerson 2003.) Rogerson's rebuttal was commissioned by Cox Communications at a time when Cox seeking to justify *a la carte* regulation of cable programming on the grounds that cable rates were rising and that programming costs (specifically, ESPN's license fees) were to blame. See below for a discussion of Cox's "revised and extended" views on this issue.

[19] GAO 2004 at 3.

[20] GAO 2004 at 9.

[21] GAO 2004 at 11.

programming," and "improve[ed] the quality of programming generally."[22] All of these findings are consistent with our analysis above, and explain why any meaningful analysis of cable rates and programming costs must take into account changes in the quality and quantity of programming being offered to cable subscribers.

Rogerson's second citation for the proposition that programming costs are responsible for rising cable rates is his own report. Based on our 2003 empirical analysis of MVPD cost structures, he calculated that net programming costs (after a partial correction to reflect the value of increasing advertising revenues) had risen by $2.96 per subscriber between 1999 and 2002, and then compared that figure with the increase in basic cable rates of $7.06 over that period of time. His conclusion, which he repeats in his new report, is that "42% [$2.96/$7.06] of the actual rise in subscription prices for cable TV can be explained by the rise in programming costs in the sense that this is the amount prices would have had to rise in order for cable systems to recover their increased programming costs."[23]

This conclusion is nonsense, as can been seen by applying Rogerson's methodology to the rest of the cost picture (which we presented as part of the same analysis from which Rogerson drew his $2.96 figure).[24] When we look at other costs, we see that "Capital Expense" rose by $5.05 between 1999 and 2002, while "Other Operating Expense" rose by $7.33. If we applied Rogerson's methodology to these figures (i.e., divide each by the $7.06 increase in monthly cable rates) we would conclude that Capital Expenses "explain" 72% ($5.05/$7.06) of the "actual rise in

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[22] GAO 2004 at 10.
[23] Rogerson 2003 at 7.
[24] See 2003 Report at 12, Figure 5.

subscription prices," while Other Operating Expenses "explain" 104% ($7.33/$7.06). The three factors taken together, in other words, "explain" 218% (42% + 72% + 104%) of the rise in cable prices.

Our 2003 conclusion – that programming costs accounted for only about 22% of the increase in cable costs between 1999 and 2002 – was based on a detailed examination of cable system expenses over that period of time. We found then that the increases in capital spending and non-programming operating costs associated with the cable operators' decision to upgrade their networks to provide digital television, Internet access, telephony and other services, were a "far more significant source of cost increases than programming."[25] We also noted that the advanced broadband, telephony and HDTV services made possible by the cable operators' investments "have not yet been fully realized; and thus despite the fact that they are not yet benefiting from the increased costs of the new technologies, basic cable subscribers are bearing the costs of these upgrades."[26]

Now, nearly three years later, the transition from analog to digital is largely complete. As shown in Exhibit Seven below, cumulative capital expenditures now total over $80 billion (about $1,250 per subscriber), but as of 2004, 97% of cable subscribers were served by systems offering digital programming, 95% by systems offering cable internet access and 29% by systems offering telephony.[27]

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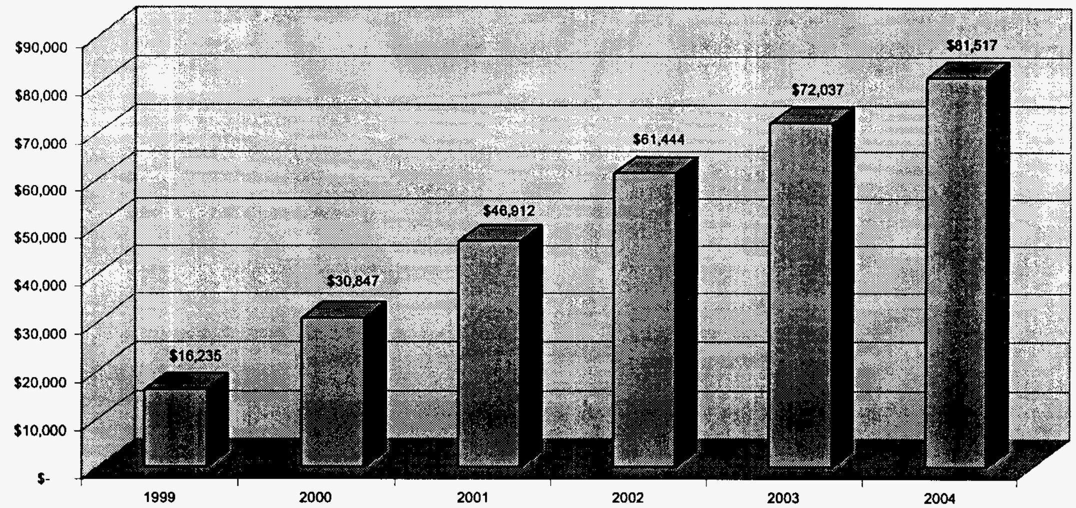
[25] 2003 Report at 17. Our findings were largely in accord with those of a May 2003 NCTA White Paper. See National Cable & Telecommunications Association, "Cable Pricing, Value and Costs," NCTA White Paper (May 2003).
[26] 2003 Report at 17.
[27] Cable Price Report at ¶37, Table 10.

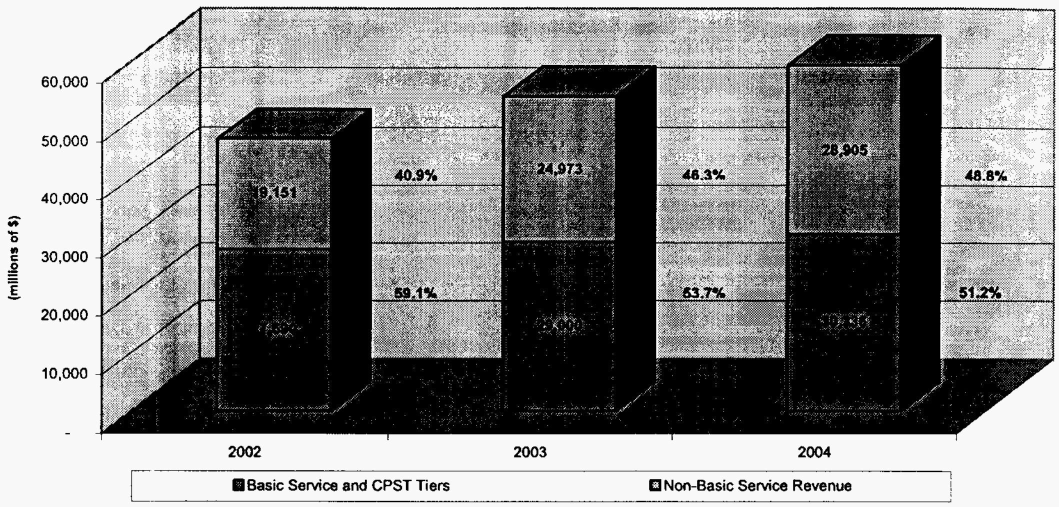
EXHIBIT SEVEN:
Cumulative Investment in Plant by Cable Operators
1999-2004 ($ million)



SOURCE: Kagan World Media, " Broadband Cable Financial Databook 2004

Not surprisingly, as illustrated in Exhibit Eight below, revenue from advanced services has grown at a far more rapid rate than revenue from basic service, growing by 51% from $19.1 billion in 2002 to $28.9 billion in 2004, compared with growth in basic service revenue of only 9.6% over the same period. Non-basic revenue represented just over 40% of total revenue in 2002, but had grown to nearly 49% in 2004.

EXHIBIT EIGHT:
Revenue from Basic Cable vs. Other Revenues, 2002-2004



SOURCE: Kagan, "Broadband Cable Financial Databook," 2004.

The rising revenue share accounted for by advanced services raises important methodological issues with respect to the correct allocation of costs, however. As the Commission recognizes in its Cable Price Report,

> The nature of cable service has changed significantly in recent years with the emergence of digital cable, Internet access, and telephony as important new services so that these new services now represent significant sources of cable system revenues and costs. A substantial portion of these costs are incurred to support all system services jointly and, therefore, cannot be attributed directly to basic and expanded basic cable services.[28]

Thus, "there is no uniform way to allocate these joint costs to specific lines of business or service"; and, "to provide a complete picture, it would be necessary to take into account revenue changes that might offset increases in costs."[29]

We agree that cable operators' changing revenue structures now make it practically impossible to accurately allocate costs across different services, and we

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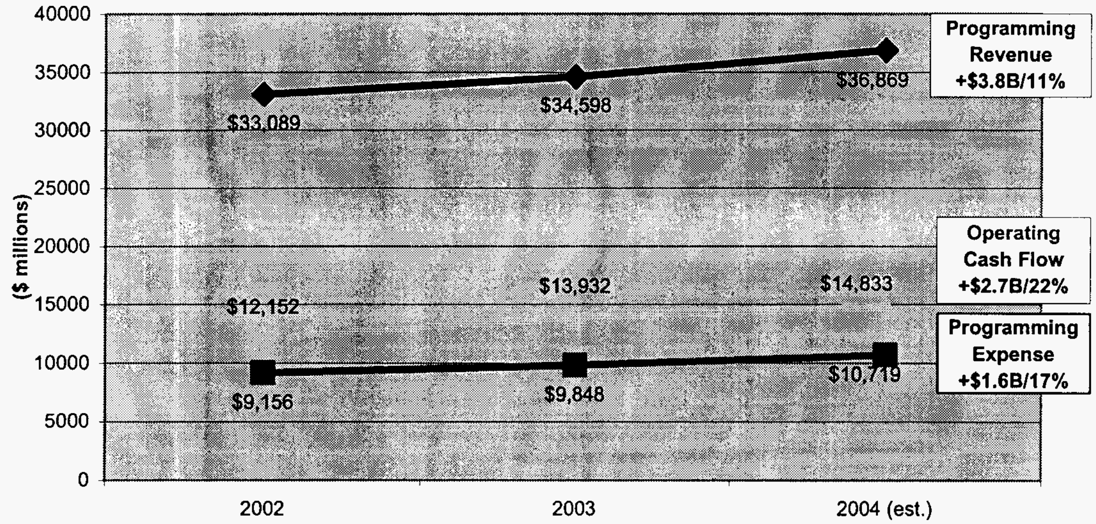
[28] Cable Price Report at 10.

[29] Cable Price Report at 10.

therefore do not attempt to update our 2003 estimates.[30] In Exhibit Nine, we show total cable programming costs, programming revenues and overall operating profits for the seven largest cable operators for 2002-2004. While programming costs rose by $1.6 billion, both revenues (+$3.8 billion) and operating profits (+$2.7 billion) rose by much more; and, programming costs represent less than 30% of revenues throughout the period.[31] These figures show that our 2003 conclusion, that programming costs "are not a primary driver of retail rates," remains valid today.

EXHIBIT NINE:
Programming Revenue, Programming Expense and Operating Cash Flow
Major Cable Operators, 2002-2004



SOURCE: Morgan Stanley Equity Research Report, "Bundling and the Battle for Basic," October 12, 2004.

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[30] We believe, however, that our 2003 results are still broadly representative of the relationships between programming costs and other costs for basic cable service – i.e., that programming represents a relatively small fraction of total costs.

[31] Two caveats: First, these figures represent total programming cost, much of which is associated with programming not owned by broadcasters and thus not affected by retransmission consent. Second, the reader who may be tempted to divide $1.6 billion by $3.8 billion and conclude that "42% of the actual rise in subscription [revenues] for cable TV can be explained by the rise in programming costs in the sense that this is the amount [revenues] would have had to rise in order for cable systems to recover their increased programming costs," should first see the discussion at 10-11 above.